WHAT ABOUT SOCIAL SECURITY?

The Economic Security Bill was passed in 1935. It created the Social Security program for the purpose of providing economic security for the elderly disabled and unemployed. There are two philosophical trends of thought--"We have a social obligation to help provide for those who are unable to provide for themselves," OR "Let them starve, the bastards".

It is anticipated that Social Security will enter a deficit phase (paying out more that it takes in) [NOTE: NOT BANKRUPT, JUST DECLINING IN TRUST ASSETS] by 2018 (maybe earlier). So, can we all agree that Social Security is a problem we need to solve? Solutions range from privatizing it (bad) to trashing it (worse) to reforming it (hmmm....). Here are provoking thoughts by renowned DALBAR President, Lewis Harvey.

SOCIAL SECURITY: A BAD IDEA?

"Social Security laws assure the elderly that America will always keep the promises made in troubled times a half century ago." Ronald Reagan (1983)

I read where some of our erudite congresspersons have been once again floating around the idea of privatizing Social Security. Does anybody really want Wall Street meddling with our retirement money? Once upon a time the rationale was that allowing us to invest in markets would increase our retirement holdings. Financial advisors were salivating.

For many Americans, Social Security will provide virtually ALL of their retirement income. (Don't forget it also includes disability income and Medicare.) Among all beneficiaries 65 and older, 42% of single persons and 22% of married couples rely on Social Security for almost all (90% or more) of their income.

But it's going bankrupt in 2037 or 2018 or next year, right? After all I read it on the internet. No it's not!

Alarmists throw around crisis dates based on irrational assumptions that support their point, no matter how pointless it may be. The facts are that Social Security estimates its excesses will be depleted in 2037 to the extent that they will be able to fund only 78% of benefits. Not bankrupt! But, no one knows exactly what happens when, financially, especially our government, because there are two dynamics taking place now:

1. People are working longer and deferring full Social Security payments and
2. Some people are taking Social Security early.

Both dynamics cost the system LESS than projections which are based on full Social Security withdrawals.

Still, even though the Lohrs collect Social Security benefits (and Medicare--Thanks to all of you who keep contributing, enabling us to not work), I do NOT contend that Social Security is the greatest thing since sliced bread. It is not.

First of all it's the largest Ponzi scheme ever, paying old workers with new workers' money. It dwarfs Bernie Madoff, and like every Ponzi scheme, it will not be able to continue indefinitely.

But the bigger problem, according to my friend and colleague, Louis Harvey, President of DALBAR, the prestigious financial research firm, is that it is a bad deal for the American worker, for whom every $1 paid over a lifetime is worth only $1.55.

That same dollar if paid into U.S. Government Bonds over the same lifetime would be worth $5.31.

According to Harvey, "The 'pay as you go' system means that the money paid into Social Security doesn't remain there long enough to earn much interest or to appreciate. In fact, the reason that there is any appreciation at all is the higher tax on succeeding generations and the interest on any surplus paid in and borrowed by the government."

So, we should all get behind the privatization of Social Security? Right? NO, the idea is ill-conceived and has serious flaws. Consider:

• Poor investment returns will hurt some participants. Think bad investment choices (we all make them) and bad market cycles. Since 2000, the U.S. stock market as measured by the S & P 500 index is down 2.7%. Timing matters.

• No help in investing except for charlatan financial advisors who will charge you 1% for their bad advice.

• A government-run managed account platform. Think monopoly: increased costs and declining performance.

But Louis Harvey has the only reasonable solution I ever heard. He said we need to permit American workers to redirect 40% of their Social Security tax into an existing or new 401(k), or other individual retirement account in exchange for waiving rights to 40% of their Social Security retirement benefits. (The other 60% stays in the system.) Plus set up a 3% fund to reinstate Social Security if the worker screwed up, and increase the FICA cap to fund the transition from the Ponzi scheme to a sound investment plan.

The goal should be to protect workers from poor market cycles and poor investment choices, and allow competition to drive improvements and decrease costs.

Until then, I look forward to continuing to collect the benefit money you're paying for. Thanks again.

Social Security: A bad deal and how to fix it
By Louis S. Harvey
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There are two dominant misconceptions about the Social Security system: that there is no problem and that the system will fail in 2018. Neither is true.

Social Security tax, which started in 1935 at 1%, now exceeds 10%. The baby boomers will cause a surge in tax rates when they retire.

Even though, the tax rate dropped for 2011, it is inevitable that the tax rate will eventually reach a level where a majority of taxpayers will oppose further increases (a taxpayer revolt). No one knows today what level of tax will cause the revolt - is it 15%, 20%, 30% or 50%?

There is a structural problem with Social Security. The problem is that it requires every generation to pay more taxes than its predecessor - in essence, it's a Ponzi scheme. Like any Ponzi scheme, it is safe to say that the current structure can't continue indefinitely.

The 2018 date of failure is pure conjecture based on arguably wrong assumptions. Even those projecting that date don't necessarily claim that the system will fail but merely that deficit spending will begin then.

The possibility of either event occurring then is unknowable and unlikely, because of the irrational assumptions on which that date is based. Assumptions include that all American workers will retire and be unproductive after 65 and that fertility rates, immigration and the economy will remain the same as they are today.

There is a real problem with Social Security today, but it involves neither of the misconceptions described. The problem is that it is a bad deal for the American worker, for whom every $1 paid over a lifetime is worth only $1.55.

The same dollar paid into a stable-value fund would be worth $2.78, and it would be worth $5.31 if U.S. government bonds were used and $7.45 if an investment tracking the Standard & Poor's 500 stock index were used.

The "pay as you go" system means that the money paid into Social Security doesn't remain there long enough to earn much interest or to appreciate. In fact, the reason that there is any appreciation at all is the higher tax on succeeding generations and the interest on any surplus paid in and borrowed by the government.

Recognizing the structural problem and the poor investment that Social Security represents, some legislators are considering a reform in which the government would offer managed accounts to American workers in exchange for reduced future Social Security benefits. That is intended to transition future generations away from the Ponzi scheme and to take advantage of market rates of return.

While noble in its intent, this plan has several enormous flaws and should be revised. The major flaws are:

• Poor investment returns could hurt some participants. Participants who make unwise investment choices or are caught in bad market cycles could be adversely affected.

• No decision support system is contemplated to assist workers in making prudent decisions. All successful defined contribution plans include enrollment meetings and/or professional advisers who assist participants in decision making.

• The administrative cost at startup will erode principal and returns for years to come. A managed-account Social Security system that starts with 174 million accounts and no assets, with an unknown rate of accumulation, will be a drain for many years.

• The lack of competitive forces will stall innovation and escalate costs. A Social Security-run managed-account system is a monopoly that won't have competitive forces to stimulate improvements. Like any monopoly, performance can be expected to decline and costs to increase.

• A new force will be created that will reduce investment results for all investors. If the Social Security system becomes the sole fiduciary, no other pension fund can possibly compete or be held accountable for performance as long as they outperform Social Security. The Social Security managed account will become the benchmark and replace independently constructed indexes for all pension funds and ultimately for all investments.

• No funding of the transition cost is contemplated. The proposed use of debt to fund transition costs merely defers the tax until the debt has to be paid.

In spite of the flaws in the proposed solution, the structural problem and the unconscionably low returns remain, and thus, action needs to be taken. Here is how we would resolve things:

• Permit American workers to redirect 40% of their Social Security tax into an existing or new 401(k), 403(b), 457 or individual retirement account in exchange for waiving rights to Social Security retirement benefits. Workers will be able to assess if they have sufficient time to realize a benefit from the redirecting of the 40%. Advisers and other decision support systems will help each worker to determine when it is in their best interest to redirect.

- Use 3% of Social Security taxes to establish a fund that permits means-tested hardship reinstatement of Social Security benefits.

- Remove the cap on Federal Insurance Contributions Act contributions to provide the funding for the transition costs.

These actions will utilize existing retirement plans to correct the flaws in the current proposal. Specifically:

- Workers are protected from market cycles and poor investment choices.

- Decision support systems already exist and don't have to be re-created.

- Administrative startup costs have already been paid, and diverted Social Security funds can immediately begin to earn a return.

- Competitive forces that exist will continue to drive improvements and reduced costs.

- Independent benchmarks will continue to be relevant and create incentives to improve performance.

- Removal of the FICA cap provides the cash flow required to fund the transition from the Ponzi scheme to an investment plan.

Lou Harvey, 2010. Louis S. Harvey is president of Dalbar Inc., a Boston-based consulting firm to the financial services industry.